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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 66

ISADORE BLAU, a stockholder of Tide Water Associated Oil Company, suing on behalf of himself and all other stockholders similarly situated and on behalf of and in the right of Tide Water Associated Oil Company,

Petitioner,

—against—

ROBERT LEHMAN, ALLAN S. LEHMAN, JOHN HERTZ, JOHN M. HANCOCK, MONROE C. GUTMAN, PAUL M. MAZUR, WILLIAM J. HAMMERSLOUGH, FRANCIS A. CALLERY, FREDERICK L. EHRMAN, JOHN R. FELL, WILLIAM S. GLAZIER, PHILIP H. ISLES, HERMAN H. KAHN, EDWIN L. KENNEDY, FRANK J. MANHEIM, PAUL E. MANHEIM, MORRIS NATELSON, HAROLD J. SZOLD and JOSEPH A. THOMAS, a co-partnership, doing business under the firm name and style of Lehman Brothers, JOSEPH A. THOMAS, and TIDE WATER ASSOCIATED OIL COMPANY,

Respondents.

ON WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC., FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*.

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September 18, 1961.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

ISADORE BLAU, *Petitioner,* —*against*— ROBERT LEHMAN, ET AL., *Respondents.*	No. 66

ON WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC., FOR LEAVE TO FILE BRIEF *AMICUS CURIAE.*

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

American Society of Corporate Secretaries, Inc. (hereinafter called the Society) respectfully moves the Court for leave to file the attached brief *amicus*. The attorneys for all respondents appearing here have consented to such filing.* The attorney for Petitioner has declined to give such consent. The Securities and Exchange Commission (hereinafter called the Commission) has filed a brief *amicus* in support of Petitioner.

The Society is a New York membership corporation. Approximately 1,250 Secretaries and Assistant Secretaries

*Tide Water Associated Oil Company, a nominal defendant in the District Court, has not appeared here and its consent has not been sought.

of many of the principal corporations of the United States are members. Many of such members are also Vice-Presidents, General Counsel or Treasurers of such corporations. More than half of the corporations whose securities are listed on the New York Stock Exchange are represented in the Society.*

Many members of the Society are personally subject to Section 16(b) of the Securities Exchange Act of 1934 (hereinafter called the Act)**, with which this litigation is concerned. Further, the Society's members, because of the nature of their positions, are directly and daily concerned with problems arising under Section 16(b). They are the persons who must try to answer, as best they can, the questions of their superiors and fellow executives as to what Section 16(b) means.

Section 16(b) was presented to Congress, and adopted, as a "crude rule of thumb"*** to prevent the unfair use of inside information. It was to apply to any purchase and sale, or sale and purchase, within a six-month period of any equity security of a corporation having securities listed on a stock exchange. Any 10% stockholder, director or officer of such a corporation was to be liable for profits "realized by him" in short-swing transactions in the equity securities of his company. Congress rejected a proposal to apply the Section to persons to whom such "insiders" passed on information.†

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*None of the parties before this Court is a member of the Society. The Secretary of Tide Water is a member.

**48 Stat. 881 (1934), 15 U. S. C. § 78 (1958).

***Testimony of Mr. Thomas G. Corcoran, *Stock Exchange Practices, Hearings before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess., pt. 15 at 6557 (1934).

†See S. 2693, 73d Cong., 2d Sess. § 15(b)(3) (1934); H. R. 7852, 73d Cong., 2d Sess. § 15(b)(3) (1934).

Webster's New International Dictionary (2d ed. 1954) defines a "rule of thumb" as "any rude process or operation, like that of using the thumb as a rule in measuring; hence, judgment and practical experience as distinguished from scientific knowledge", and The Shorter Oxford Dictionary (2d ed. 1936) speaks of it as a "roughly practical method".

Thus Section 16(b) set up an objective test for liability irrespective of actual use of inside information. If designated people did designated acts, they were to be held liable regardless of good faith, and regardless of actual ignorance of any inside information. The test adopted seemed simple and easy to understand—albeit intentionally crude and somewhat arbitrary. Yet by 1953, reflecting numerous decisions in lower Federal courts, the then Chairman and a then Special Counsel of the Commission could appropriately comment that Section 16(b) is "the most subtle and least understood" of the provisions of the Act.*

The very pendency of this case demonstrates how far the actual interpretation of Section 16(b) by the lower courts, particularly the Second Circuit, has departed from the intent of Congress. The other briefs filed herein set forth specific questions for the Court's determination. The Society asks leave to file this brief because, in view of the express words of the statute and the clear Congressional intent, it is startling that such questions should even arise. They can arise only because, under the decisions of the lower courts, (*1*) *Section 16(b) has been applied without regard for economics or realities*, and (*2*) *no one can more than hazard a guess as to whom or to what transactions it may next be held to apply.* It is this appalling situation which undoubtedly has encouraged plaintiff to urge in this

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*Cook and Feldman, *Insider Trading under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 386 (1953).

suit a contention already decided squarely to the contrary in the *Rattner* case,* one of the relatively few decisions which have recognized the clear Congressional intention that the Section be applied only to a specific and limited group of persons.

The Society strongly endorses the underlying purpose of Section 16(b)—to prevent the unfair use of inside information. In the 1920's there were some flagrant examples of such unfair use. Since that time, however, the evils at which Section 16(b) was directed have been almost eliminated by other factors.**

Despite the existence of such other effective preventives, the courts, the Commission and various textwriters have vied with each other in distorting Section 16(b)—clear enough in its purpose and on its face—into a veritable mantrap. Such distortion might not seem so far beyond the pale in cases where actual unfair use of inside information was involved, bearing in mind the Congressional objective. However, although there have been more than 50 reported cases under Section 16(b), there has never been a finding in any of those cases that inside information was actually used. The findings of the trial court below make it clear that the instant case did not involve such use.

Furthermore, as the lower courts have recognized, Section 16(b) offers inviting opportunities for champerty. *E.g., Magida* v. *Continental Can Co.*, 231 F. 2d 843 (2d Cir. 1956).

Section 16(b) was intended to be and is an arbitrary rule. Once it has been found that the purportedly objective

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**Rattner* v. *Lehman*, 193 F. 2d 564 (2d Cir. 1952).

**For example, high income tax rates on true short-swing transactions, the anti-fraud provisions of the Act and the Securities Act of 1933, vastly improved accounting standards, strengthened rules of the Stock Exchanges (particularly insistence on prompt publicity of corporate developments), the establishment of The National Association of Securities Dealers, Inc., and the prevalence of better corporate reporting.

standards it sets forth have been met, recovery follows inexorably, regardless of the defendant's good faith or the absence of actual use of inside information. Moreover, as applied by the lower courts, the penalty it imposes has often proved to be extremely drastic—much more so, we believe, than Congress intended. We think the Section *should* be used and strictly enforced for the purposes for which it was intended. But it is not fair or justifiable to apply such a statute except as a "crude rule of thumb". We think it has far too often been construed backwards—starting out with the conclusion and working back to an "interpretation" of the simple words used. That method does violence to the traditional canon of construction which calls for the strict interpretation of statutes which impose a penalty. See, *e.g., Commissioner* v. *Acker,* 361 U.S. 87 (1959).

The parties herein are properly concerned with establishing their positions on the facts of the case. The Society, however, respectfully requests that the Court, in considering the specific issues in the case, also give consideration to the broader aspects of the problem. The attached brief is submitted in the hope that it will assist the Court so to do.

Respectfully submitted,

DONALD C. SWATLAND

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Of Counsel.

September 18, 1961

BRIEF OF AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC., AS *AMICUS CURIAE*

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ON WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC., AS *AMICUS CURIAE.*

INTEREST OF *AMICUS CURIAE*

The interest of American Society of Corporate Secretaries, Inc., as *amicus curiae* is set forth in the Society's motion for leave to file this brief *amicus,* to which motion this brief is annexed.

SUMMARY OF ARGUMENT

Section 16(b) of the Securities Exchange Act of 1934 was designed by Congress to establish objective criteria for the liability of an insider for short-swing profits, without regard to the insider's good faith or the absence of actual use of inside information. The Section 16(b) remedy as applied by the lower Federal courts has gone far beyond the intent of Congress and with extremely drastic consequences. In addition, the decisions of the lower courts

have turned the Section into an open invitation to champertous lawsuits, without the usual procedural safeguards for stockholder actions.

In previous decisions of the lower courts, application of Section 16(b) has often been stretched so far beyond the intent of Congress that in many situations it is now unclear to whom the Section applies and what transactions it covers. One of the relatively few cases in which the lower courts have properly recognized the Congressional intent that the Section be applied only to a specific, limited class of persons is the *Rattner* case, in which, in circumstances indistinguishable from those obtaining here, the Second Circuit held almost ten years ago that the Section did not cover partners of insiders. Petitioner nevertheless would compound the already confused state of the law, asking this court to reject the well-established *Rattner* rule and to hold that not only those expressly designated by the Section are covered thereby, but also other persons whom Congress explicitly decided should not be covered. Petitioner alternatively urges this Court to rule that a person covered by the Section is liable not only for short-swing profits "realized by him", as provided by the Section, but also for profits realized by his partners.

The Section 16(b) remedy should be strictly limited to the transactions and persons expressly designated therein.

ARGUMENT

I. THE INHERENT HARSHNESS OF SECTION 16(b) HAS BEEN ACCENTUATED BY THE LOWER COURTS.

The Congressional purpose in adopting Section 16(b)* of the Securities Exchange Act of 1934** was to prevent insiders from making unfair use of inside information. To accomplish that purpose Congress chose to adopt an objec-

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*48 Stat. 896 (1934), 15 U. S. C. § 78p(b) (1958).
**48 Stat. 881 (1934), 15 U. S. C. § 78 (1958).

tive test for liability of an insider for short-swing profits irrespective of his good faith and without any proof of actual use or misuse of inside information.* Section 16(b) is not unlike a highway speed limit in that regard. Once the criteria of the objective test have been met, liability of the insider follows inexorably, whether or not, under the particular circumstances of the case, such liability would serve the legislative purpose. As Petitioner has so candidly observed, "it is quite clear that the statute is wholly unconcerned with either the fairness of a particular transaction or the 'insider's' good faith or good intentions in effecting it". Petitioner's brief, p. 18.

The remedy which Congress adopted was simply recovery by the corporation of any short-swing profits realized by an insider.

> "The objective was not to punish but to deter the persons in these three categories—directors, officers, 10% beneficial owners—from making improper use of information gained in a representative capacity. The practices could not be prevented *in toto* but Congress sought to take the profit out of what it considered improper conduct." *Adler* v. *Klawans*, 267 F. 2d 840, 844 (2d Cir. 1959).

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*Framing a statute to prevent the unfair use of inside information for profit presented certain obvious problems of proof. For that reason Congress adopted an *objective* test for liability under Section 16(b) which does not require the plaintiff to prove actual unfair use of such information. Conversely, the test adopted, although covering many circumstances where such unfair use might occur, does not cover all such circumstances. Thus, for example, under Section 16(b) a transaction based on the unfair use of inside information does not create a right to recovery of profits realized unless it can be paired with another transaction to form a purchase and sale, or a sale and purchase, of the equity security involved. Similarly, Section 16(b) does not create liability where the purchase and sale based on inside information have not occurred within six months of each other. And it is also true that the Act does not provide recovery from a person not an insider who nevertheless profits from inside information. See 2 Loss, Securities Regulation 1042-43 (2d ed. 1961); Cole, *Insiders' Liabilities under the Securities Exchange Act of 1934*, 12 Sw. L. J. 147, 150 n. 22 (1958).

Nevertheless, the application of the Section's remedy has resulted in the imposition of extraordinary penalties.

The first case to arise under Section 16(b), *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (2d Cir.), *cert. denied*, 320 U. S. 751 (1943), presented the problem of computing Section 16(b) profits where there had been multiple purchases and sales of securities within a six-month period. After stating that Section 16(b) was designed "to squeeze all possible profits out of stock transactions", 136 F. 2d at 239, the court rejected all usual accounting methods, such as matching stock certificates, the "first-in, first-out" method and average cost. The court instead established a rule that profits should be calculated by matching purchases of securities at the lowest price with sales at the highest, thereby achieving the greatest possible recovery for the corporation.

The application of such a rule may result in the recovery of "profits" under Section 16(b) even where the insider has actually suffered a loss during the six-month period. Exactly that situation arose in *Gratz* v. *Claughton*, 187 F. 2d 46 (2d Cir.), *cert. denied*, 341 U. S. 920 (1951), where the defendant was held liable for more than $300,000 in "profits" notwithstanding the fact that the net result of his transactions was a *loss* in excess of $300,000.* Clearly, the insider in that case made poor use of his inside information, if any he had.

To illustrate the prevailing rule of damages under Section 16(b):

(1) First a simple example. An insider (a) buys a share at $20, (b) the next day sells it at $19, (c) buys another share five months later at $10 and (d) the following day sells it at $9. In fact, he is out-of-pocket $2. As Section 16(b) has been applied, however, he has

*See *Adler* v. *Klawans*, 267 F. 2d 840, 847-48 (2d Cir. 1959).

sold a share at $19 and bought another share at $10, *and has therefore made a recoverable "profit" of $9!* No offset whatsoever is allowed for the $11 loss which results from matching the other two transactions within the six-month period (the $20 purchase and the $9 sale).

(2) Examine then a more complex case. An insider, at the beginning of 1961, owned 2,000 shares of his company's stock which he bought in 1947 at $10 a share. He makes the following transactions:

Date	Transaction	No. of Shares	Price	Cost	Proceeds
1/3/61	Purchase	400	$30	$12,000	$....
2/1/61	Purchase	800	48	38,400	....
3/1/61	Sale	500	50	....	25,000
6/30/61	Sale	700	20	....	14,000

He thus ends up with 2,000 shares, the same number that he started with. The cost of the shares that he bought in 1961 was $50,400. The proceeds received from the sale of the shares in 1961 was $39,000, giving him an actual loss of $11,400 on the transactions within the six-month period (disregarding the probability that he will pay long-term capital gains taxes on the sale of some of the shares previously held).

Now apply the Section 16(b) rule of damages:

(i) the purchase of 400 shares on January 3 at $30 would be matched against the sale of 400 of the 500 shares sold March 1 at $50, showing a "profit" of $8,000; and

(ii) the purchase of 100 of the 800 shares bought February 1 at $48 would be matched against the sale of the remaining 100 shares of the 500 shares sold March 1 at $50, creating a recoverable "profit" of $200,

or a total recoverable profit of $8,200.

Note that there are no transactions against which to match, at a "profit", the sale of 700 shares on June 30 at

$20 or the purchase of 700 of the 800 shares bought at $48 on February 1, so they are disregarded in the computation.

To summarize, the insider who has actually lost $11,400 (before paying his taxes) also owes $8,200 to his company under Section 16(b).

The harshness of the Section 16(b) remedy as imposed by the lower courts is all the more evident in light of the fact that Congress declined in 1934 to make short-term trading by insiders unlawful;* that it was specifically represented to Congress that an insider was free to sell stock of his company within six months after purchasing it, the only consequence being that he would have to forego any profit;** and that Congress specifically rejected any penalty provision.***

The hazards for corporate insiders under Section 16(b) are compounded by the fact that the Section has been made an attractive instrument of champerty, readily available for harassment purposes even where the litigation is utterly without merit. The Act does not authorize the allowance of fees to the attorneys for successful Section 16(b) plaintiffs. But, in the *Smolowe* case, an attorney's fee was allowed and the Second Circuit, speaking through Judge Clark, stated that "since in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of § 16(b), the allowance must not be too niggardly". 136 F. 2d at 241. Since that time the door has been opened wide. Contrary to the usual rules, the courts have held in applying Section 16(b) that the plain-

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*See S. 2693, 73d Cong., 2d Sess. § 15(b) (1934); H. R. 7852, 73d Cong., 2d Sess. § 15(b) (1934).

***Stock Exchange Practices, Hearings before Senate Committee on Banking and Currency*, 73d Cong., 2d Sess., pt. 15 at 6557 (1934).

***See S. 2693, 73d Cong., 2d Sess. §§ 15(b), 24 (1934); H. R. 7852, 73d Cong., 2d Sess. §§ 15(b), 24 (1934).

tiff need not have been a stockholder at the time of the transactions of which he complains;* that the plaintiff, even though he owns only a few shares bought after the event, need not put up security for costs of litigation;** and that the bad faith of plaintiff is not a sufficient reason for denying recovery or even for denying fees to the attorney.*** Thus Judge Ryan has said,

> "I have reluctantly come to the conclusion that the probable existence of such [champertous] conduct in these suits should not bar the attorney from receiving an allowance. . . .
>
> ". . . . Whatever the ethics of the situation, the purpose of the statute is thus fulfilled." *Magida v. Continental Can Co.,* 176 F. Supp. 781, 782-783 (S. D. N. Y.), aff'd, 231 F. 2d 843 (2d Cir.), *cert. denied,* 351 U. S. 972 (1956).

If such had been the intent of Congress, one wonders why it required that the plaintiff in a Section 16(b) case be a security holder at all.

The matters discussed above illustrate the reasons for the Society's concern with any extension of the Section to persons and transactions not contemplated by Congress—*i.e.,* persons and transactions defined in any way other than in accordance with the plain words of the Section.

II. SECTION 16(b) SHOULD BE APPLIED ONLY TO OFFICERS, DIRECTORS AND 10% BENEFICIAL STOCKHOLDERS.

This case involves a specific aspect of a problem in which the Society is vitally interested—to whom does

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**Magida* v. *Continental Can Co.*, 231 F. 2d 843 (2d Cir.), *cert. denied,* 351 U. S. 972 (1956); *Dottenheim* v. *Murchison,* 227 F. 2d 737 (5th Cir. 1955), *cert. denied,* 351 U. S. 919 (1956); *Benisch* v. *Cameron,* 81 F. Supp. 882 (S. D. N. Y. 1948).

***Truncale* v. *Blumberg,* 80 F. Supp. 387 (S. D. N. Y. 1948).

****Magida* v. *Continental Can Co.,* 231 F. 2d 843 (2d Cir.), *cert. denied,* 351 U. S. 972 (1956).

Section 16(b) apply? In light of the supposedly objective nature of the Section's test for liability and the harshness of its remedy, that problem should never arise. The express words of the statute define the persons covered by the Section in uncomplicated language. Such persons are "the beneficial owner of more than 10 per centum of any class of any equity security" of an issuer and "a director or an officer" of an issuer.* Such persons, if they do the proscribed things, are liable regardless of good faith.

To be sure, the purpose of Section 16(b)—to prevent unfair use of inside information for profit—might have been extended to a wider class of persons. Congress might on the other hand have required actual proof of misuse of inside information. But Congress did neither. The original bills introduced in Congress provided for recovery of "any profit made by *any person*, to whom . . . unlawful disclosure [of any confidential information regarding or affecting any registered security] shall have been made . . ."** (Emphasis supplied.) However, that provision was eliminated from the statute as finally enacted, "presumably because the burden of proof made enforcement unfeasible". *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 236 (2d Cir.), *cert. denied*, 320 U. S. 751 (1943). On the other hand, Congress eliminated a requirement in the original bills that *actual* misuse of information be proved. Thus Congress, for obvious reasons, drew two arbitrary lines—(1) *only* 10% stockholders, directors and officers were to be covered and (2) they would be liable *without fault*. Petitioner here seeks to erase the first of those lines.

It is argued that Congress did not mean what it said, but that the Section should apply to the persons designated therein and also to others who may be in positions to acquire

*Section 16(a), 48 Stat. 896 (1934), 15 U. S. C. § 78p(a) (1958).

**S. 2693, 73d Cong., 2d Sess. § 15(b)(3) (1934); H. R. 7852, 73d Cong., 2d Sess. § 15(b)(3) (1934).

inside information. Petitioner would not even limit the broadened application he urges to persons who actually use inside information unfairly, but would extend it to anyone who *might* use such information. On the facts of this case Petitioner must be saying that persons not covered by the Section are nevertheless liable, even when they did not use inside information. This goes some distance beyond the original bills which Congress rejected.

Section 3(a)(7) of the Act* defines "director" as "any director of a corporation" (thus obviously equating the term with its well known meaning in corporation law and in business and legal parlance) and in addition "any person performing similar functions with respect to any organization, whether incorporated or unincorporated". It would thus seem clear without more that Congress did not intend the Section to apply to partners of directors.

The present litigation was instituted despite the fact that it was squarely held almost ten years ago that no Section 16(b) liability exists in the circumstances of this case. In 1952, the Court of Appeals for the Second Circuit held in *Rattner* v. *Lehman,* 193 F. 2d 564 (2d Cir. 1952), that the term "director" as used in the Act did not encompass the partners of a director. The *Rattner* decision, one of the relatively few by the lower courts which have properly recognized the clear intent of Congress to restrict Section 16(b) applicability to a specific and limited group of persons, has never been questioned by any court, nor by the Commission prior to the inception of this case, and has, beyond all doubt, been widely relied upon by the business community.

Petitioner's hope that by bringing this suit he might obtain reversal of that well-established rule apparently has its genesis in the fact that, notwithstanding the clear statutory delineation of the persons to whom Section 16(b) ap-

*48 Stat. 883 (1934), 15 U. S. C. § 78c(a)(7) (1958).

plies, interpretations of the Section by the lower courts have often strayed far beyond that limit. Although the Section provides for recovery of "any profit realized by [an insider] . . . from any purchase and sale, or any sale and purchase, of any equity security", the Second Circuit has stated that a person may be liable "who was a director, officer or beneficial owner *at some time*", but not necessarily at the time of both the purchase and the sale. *Adler* v. *Klawans,* 267 F. 2d 840, 844 (2d Cir. 1959). Such a result is surprising enough in the case of an officer or a director since the statute expressly refers to *pairs* of transactions by insiders (*i.e.*, "any purchase *and* sale" or "any sale *and* purchase"), and it would seem to be expressly prohibited by Section 16(b) in the case of a 10% stockholder. Section 16(b) provides "[t]his subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved".* Nevertheless, the Second Circuit, speaking through Judge Clark, in the face of that express statutory language, has held that the purchase by which a person became a 10% stockholder may be used as a basis for liability, ignoring the fact that the stockholder did not even become an insider (and hence did not even presumptively obtain access to confidential information) until *after* he had acquired a 10% interest. *Stella* v. *Graham-Paige Motors Corp.,* 232 F. 2d 299 (2d Cir.), *cert. denied,* 352 U. S. 831 (1956). *But see Arkansas La. Gas Co.* v. *W. R. Stephens Inv. Co.,* 141 F. Supp. 841 (W. D. Ark. 1956).

In *Colby* v. *Klune,* 178 F. 2d 872 (2d Cir. 1949), the Second Circuit, through Judge Frank, said, by way of dictum, that if it were not for the Commission's Rule 3b-2 (see below) it would "construe" the word "officer" as used in Section 16(b) to include

> "a corporate employee performing important executive duties of such character that he would be likely,

*48 Stat. 896 (1934), 15 U. S. C. 78p(b) (1958).

> in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions". 178 F. 2d at 873.

That revealing dictum clearly has no relation to the word "officer" as it is understood and used in the business community and, presumably, by Congress.

It is also contrary to the SEC's published rules. Since 1934 one of the Commission's rules has defined "officer" as "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers".* The Commission's General Counsel has indicated that "any other person" includes an officer's assistant whose "chief is so inactive that the assistant is really performing his chief's functions".** While this slight extension of the words of the rule may perhaps be justifiable, no further extension is warranted.

Fortunately, the *Colby* dictum has not been adopted by anyone. In fact, it has been rejected by other courts (*Lockheed Aircraft Corp.* v. *Campbell*, 110 F. Supp. 282 (S. D. Cal. 1953); *Lockheed Aircraft Corp.* v. *Rathman*, 106 F. Supp. 810 (S. D. Cal. 1952)) and by the Commission (Securities Exchange Act Release No. 4754 (Sept. 24, 1952), 17 Fed. Reg. 8900-2 (1952)). But the possibility that such a "method" of statutory construction might prevail—this time in connection with the definition of "director"—is of direct concern to the Society.

The Court for these compelling reasons alone should make clear once and for all that "director" means "director", that "officer" means "officer", and that "10% stockholder" means just that. Such is the essence of this case.

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*SEC Rule 3b-2, 17 C. F. R. § 240.3b-2 (1949).

**Securities Exchange Act Release No. 2687 (Nov. 16, 1940), 11 Fed. Reg. 10981-2 (1946).

III. THE UNDULY BROAD CONSTRUCTION BY THE LOWER COURTS OF THE TERMS "PURCHASE" AND "SALE" UNDER SECTION 16(b) REQUIRES THAT THE SECTION BE APPLIED ONLY TO THOSE PERSONS EXPRESSLY DESIGNATED BY THE STATUTE.

It would seem that the lower courts, in view of the inherent harshness of Section 16(b) and its applicability regardless of actual fault, would have been quick to recognize the importance of restricting its application to transactions clearly specified by Congress. Quite to the contrary. Violence has also been done by the lower courts to the statutory designation of transactions covered by Section 16(b). Those transactions are "any purchase and sale, or any sale and purchase," of an equity security within six months. The unwarranted judicial expansion of those terms—plus even further expansion advocated by some legal writers—has made Section 16(b) even more fraught with peril. It is thus evident how important it is to the Society and the business community that the Court hold here that the Section should be confined to the persons whom Congress explicitly specified the Section was to cover.

One aspect of that problem, although not presented for determination by this Court, was raised on the cross-appeal below—was the conversion by Lehman Brothers of its Tide Water common stock into shares of a new issue of preferred a "purchase" of that preferred under Section 16(b)?

The words "purchase" and "sale" have commonly accepted meanings. In addition, the Act itself defines them to include contracts of purchase and sale.* But the words "purchase" and "sale" and "contract" have also been contorted to cover transactions never intended by Congress. It

*Section 3(a)(13), 48 Stat. 884 (1934), 15 U. S. C. § 78c(a)(13) (1958).

is obvious, of course, that a certain flexibility in the application of Section 16(b) is necessary in order to prevent evasion of its terms. In actual practice, however, the Section has been applied not to cases of evasion, but virtually to any situation in which an insider *could* have used inside information to make a profit, even though he did not actually do so. Thus, conversion of a convertible security into common stock, even after a call for redemption, has been held a "purchase" of the common stock. *Park & Tilford, Inc.* v. *Schulte,* 160 F. 984 (2d Cir.), *cert. denied,* 332 U. S. 761 (1947). *Contra, Ferraiolo* v. *Newman,* 259 F. 2d 342 (6th Cir. 1958), *cert. denied,* 359 U. S. 927 (1959). It has been suggested that such conversion may also be a sale of the convertible security.*

The *Schulte* case and the further suggestion of the law review writers fly in the face of the fact that the insider has exactly the same number of dollars invested in his company both before and after the conversion.

It has even been suggested that the insiders of a corporation which acquires another corporation by merger or acquisition of assets may unwittingly have sold their stock in the original corporation and simultaneously bought it back, even though the stock certificates never left their safe deposit boxes. Memorandum for the Commission as *Amicus Curiae,* pp. 7-11, *Blau* v. *Hodgkinson,* 100 F. Supp. 361 (S. D. N. Y. 1951). Moreover, a transfer by a corporation to its own majority-owned subsidiary of shares of a third company in exchange for additional shares of the subsidiary has been held a "sale", even though the court recognized that the parent corporation ended up with the same proportionate interest in the third company, and thus remained in exactly the same economic position as it had been

*Cook and Feldman, *Insider Trading under the Securities Exchange Act,* 66 Harv. L. Rev. 612, 624 (1953).

in before the transfer. *Blau* v. *Mission Corp.*, 212 F. 2d 77 (2d Cir.), *cert. denied*, 347 U. S. 1016 (1954).

Simple transactions may have incredibly far-reaching consequences. It has been suggested that the sale of a convertible security should be considered, for Section 16(b) purposes, a sale of the underlying common stock.* The court in *Truncale* v. *Blumberg*, 80 F. Supp. 387 (S. D. N. Y. 1948), indicated that the execution of an employment contract providing for the annual issuance to an employee of 5,000 warrants was a "purchase" of such warrants, relying on the statutory definition of "purchase" as including a "contract to . . . otherwise acquire"** the warrants. It was also suggested that the subsequent issuance each year of the 5,000 warrants was also a "purchase". 80 F. Supp. at 392. Thus, each year's issue of warrants was "purchased" by the employee twice—once on the execution of the contract and once on the date of issuance. Moreover, it has been argued that if a company grants an employee a stock option exercisable one year after grant and which is actually exercised two years after grant, the employee may have "purchased" the *stock*, for Section 16(b) purposes, on three dates—the date of option grant, the date it becomes exercisable and the date of exercise.*** All this despite the fact that it is perfectly clear that an option to acquire shares is neither the acquisition of those shares nor a contract to do so—it is merely a right exercisable at the optionee's discretion, not a contract obligation binding him to do anything. To compound the confusion, it is said that the employee may have "purchased" the *option* twice, *i.e.*, on the date of grant and on the date it becomes exercisable and

*Rubin and Feldman, *Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders*, 95 U. Pa. L. Rev. 468, 486 (1947).

**Section 3(a)(13), 48 Stat. 884 (1958), 15 U. S. C. § 78c(a)(13) (1958).

***Cook and Feldman, *Insider Trading under the Securities Exchange Act*, 66 Harv. L. Rev. 612, 619-620 (1953).

that such "purchase" of the option may be matched with a sale of actual securities of the same class covered thereby.* And the ultimate absurdity—it has been contended that a *gift of stock to a charity* may be a Section 16(b) *sale* which, if matched with a purchase, may create liability.** The donor may have realized a profit, so the argument goes, wholly aside from any tax implications, "in the form of prestige and community standing" or in the establishment of "a reputation for financial responsibility and business success".***

There are cases, of course, in which courts have found an absence of a Section 16(b) "purchase" or "sale". The decisions in certain of those cases, however, indicate that the court's determination was based not on a decision as to whether or not the transaction was a purchase or sale, but rather on whether or not the court could find any way in which the insider could profit from inside information. See *Shaw* v. *Dreyfus,* 172 F. 2d 140 (2d Cir.), *cert. denied,* 337 U. S. 907 (1949); *Roberts* v. *Eaton,* 212 F. 2d 82 (2d Cir.), *cert. denied,* 348 U. S. 827 (1954). As the Queen of Hearts said, "Sentence first—verdict afterwards."† Under that kind of reasoning, the hazards for a corporate insider are almost without limit. As the then General Counsel and a then Attorney of the Commission recently wrote,

> ". . . [I]t seems clear that in the Second Circuit even a transaction which does not result in change in the insider's proportionate interest may possibly be a purchase or sale within section 16(b). . . . Splits, stock dividends, reclassifications, and similar corpo-

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**Ibid.*

**Comment, *The Scope of "Purchase and Sale" under Section 16(b) of the Exchange Act,* 59 Yale L. J. 510, 528-530 (1950).

****Id.* at 528.

†Carroll, Alice's Adventures in Wonderland 199 (Caldwell ed.).

> rate devices are readily susceptible to such abusive manipulation",*

and therefore, presumably, within the reach of Section 16(b).

The risk of unwarranted application of Section 16(b) to transactions which could only by the most imaginative persons be called "purchases" or "sales" leads to startling consequences. Consider, for example, a corporation with outstanding convertible preferred stock, common stock and an option plan. There are 24 possible combinations of transactions, most of them obscure, concerning which an insider must consider the implications of Section 16(b).**

The very possibility that liability might be found by the lower courts to exist by reason of such constructions of the simple words "sale" and "purchase" should impel the Court, at the very least, to define as strictly as Congress did the persons to whom Section 16(b) applies.

IV. THE SECTION 16(b) REMEDY AGAINST AN INSIDER SHOULD BE RESTRICTED TO PROFITS ACTUALLY "REALIZED BY HIM."

Respondent Thomas, in the present case, *did not receive a penny* of the profits realized on the short-swing transactions which are the subject of the litigation. Respondents argued below that Thomas, for that reason, should not be liable for any of those profits. The courts below, however, agreed with Petitioner that Thomas' anticipatory waiver of his right to receive a share of those

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*Meeker and Cooney, *The Problem of Definition in Determining Insider Liabilities under Section 16(b)*, 45 Va. L. Rev. 949, 978 (1959).

**Possible purchases: grant of option, accrual of right to exercise option, exercise of option, purchase of preferred, conversion of preferred, purchase of common. Possible sales: exercise of option, conversion of preferred, sale of preferred, sale of common.

profits, if any should be realized, was ineffective to avoid Section 16(b) liability.

That issue is not presently before this Court. Petitioner does contend, however, as he did below and as his attorney did in the *Rattner* case,* that a director of a corporation should be liable for the entire amount of the profits realized by his non-insider partners. Such a contention is contrary to the plain meaning of the words of Section 16(b), which expressly provides for recovery from a director of "any profit realized *by him*".** (Emphasis supplied.) It also conveniently overlooks the fact, as pointed out above, that Congress rejected the proposal to make Section 16(b) apply to other persons. Furthermore, that proposition was squarely rejected in the *Rattner* case.

A member's interest in the profits earned by his partners is, before distribution, undivided but not indivisible—and the amount of such interest is limited to his specific share as provided by the partnership agreement. See *N. Y. Partnership Law,* § 52. Under no circumstances may he succeed to the complete ownership of these profits; any attempt by him to do so would be unlawful. The trial court clearly stated the nature of Thomas' interest in the profits realized by Lehman Brothers from their transactions in Tide Water stock. Had Thomas not waived his right to receive those profits, he would have been entitled to receive approximately 4% of such profits.

Nor did Thomas have anything whatsoever to do with the creation of the profits, either directly or indirectly. The trial court found as a fact that Thomas had not caused Lehman Brothers to make the transactions in Tide Water securities. It specifically found that the firm's decision to do so had been based on two articles which appeared in

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**Rattner* v. *Lehman*, 193 F. 2d 564 (2d Cir. 1952), the only other Section 16(b) case regarding short-swing profits realized by non-insider partners of an insider.

**48 Stat. 896 (1934), 15 U. S. C. § 78p(b) (1958).

The Wall Street Journal. Everything would have happened in exactly the same way even if Thomas had been on an extended vacation throughout the entire period.

Petitioner and the Commission seek to support the proposition that an insider is liable for all profits in which he has an undivided interest, even if that interest is shared with another, citing only *Walet* v. *Jefferson Lake Sulphur Co.*, 202 F. 2d 433 (5th Cir.), *cert. denied*, 346 U. S. 820 (1953). That case, however, is inapposite because the undivided interest there was the community property of husband and wife in a community property state. The court there pointed out that under the law of Louisiana the husband "is the head and master of the community and as such must be held accountable for his management thereof to the same extent as if it were his own". 202 F. 2d at 434. That reasoning is certainly not appropriate in the case of a 4% partner, who obviously has no right or power to direct the affairs of the partnership. Moreover, under Louisiana law recovery of less than the entire Section 16(b) profit would have left to the husband in *Walet* an undivided half interest in the portion of that profit remaining in the community—a result which does not obtain here.

The Commission's brief states that "if recovery were limited to the portion of the profit applicable to the partner-director, as the court below held, an investment banking firm with 20 equal partners, no two of whom were officers or directors of the same corporation, could use inside information in short-swing trading ad infinitum and never have to disgorge more than five per cent of its profits". Commission's brief p. 11. What the Commission has overlooked, however, is what Congress said. It is self-evident that there are many close relationships among members of a community (whether of a business or a social nature) in which the opportunity for exchange of inside information is present. Clearly the operative language of Section 16(b)

does not apply to persons in a position to obtain inside information by such contacts if they are not otherwise insiders. There is no justification under the Section for singling out partnerships for different treatment.

CONCLUSION

Because of the drastic nature of the Section 16(b) remedy, it is incumbent upon the courts to limit its applicability to those specific persons and transactions which Congress clearly intended to cover.

The judgment of the District Court should therefore be affirmed.

Respectfully submitted,

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September 18, 1961

Certification

I, Bruce Bromley, one of the attorneys for American Society of Corporate Secretaries, Inc., *amicus* herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 18th day of September, 1961, I served copies of the foregoing Motion for Leave to File and the annexed Brief *Amicus* in the captioned cause by causing to be mailed a copy thereof with first class or air mail postage prepaid (as appropriate) as follows:

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